No. 20,110

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant

v.

JAMES H. MARSHALL and THELMA MARSHALL,

Appellees

ON APPEAL FROM THE JUDGMENT OF
THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLANT

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OPINION BELOW

The opinion of the District Court (R. 43-47) is reported at 241 F.Supp. 30.

JURISDICTION

This proceeding involves a suit for refund of federal income taxes for 1959 in the sum of $4,575.87 brought by James H. Marshall and Thelma Marshall (herein sometimes referred to as the taxpayers) by the filing of a complaint (R. 2-5) in the United States District Court for the Southern District of California on July 19, 1963, alleging the payment of such taxes on December 27, 1962, and the timely filing of a claim for refund thereof on January 16,

1963, with a written waiver of registered mail notification of disallowance (R. 3). The District Court had jurisdiction under 28 U. S. C., Sections 1340 and 1346(a). The case was submitted to the District Court on a pre-trial stipulation of facts (R. 10-13) and written briefs (R. 14-42). The District Court resolved the legal issue in favor of the taxpayers in a memorandum of decision filed September 30, 1964. (R. 43-47.) Its findings of fact and conclusions of law (R. 48-52) and its judgment in favor of the taxpayer (R. 53) were filed January 26, 1965. Notice of appeal (R. 55) was filed by the United States on March 29, 1965. Jurisdiction is vested in this Court by 28 U. S. C., Section 1291.

QUESTION PRESENTED

Whether the District Court erred in holding that, for the purpose of determining whether gain realized by the taxpayers from the sale of their sole proprietorship business to a corporation in 1959 may be reported on the installment basis, the payments received by them on the purchase price in the year of sale, within the meaning of Section 453(b) of the Internal Revenue Code of 1954, did not include the personal obligations of the taxpayers assumed by the purchasing corporation as a part of the consideration for the sale and actually paid during the year of sale.

STATUTE AND REGULATION INVOLVED

Internal Revenue Code of 1954:

SEC. 453. INSTALLMENT METHOD.

(a) Dealers in Personal Property. --Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of

personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

(b) Sales of Realty and Casual Sales of Personalty.--

(1) General rule.--Income from--

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) Limitation.--Paragraph (1) shall apply--

(A) In the case of a sale or other disposition during a taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition--

(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price.

(B) In the case of a sale or other disposition during a taxable year beginning before January 1, 1954, only if the income was (by reason of section 44(b) of the Internal Revenue Code of 1939) returnable on the basis and in the manner prescribed in section 44(a) of such code.

* * * * * *

(26 U.S.C. 1958 ed., Sec. 453.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.453-4 Sale of real property involving deferred periodic payments.

(a) In general. Sales of real property involving deferred payments include (1) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (2) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

(b) Classes of sales. Such sales, under either paragraph (a) (1) or (2) of this section, fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of real property which may be accounted for on the installment method, that is, sales of real property in which (i) there are no payments during the taxable year of the sale or (ii) the payments in such taxable year (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, or

(2) Deferred-payment sales of real property in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed 30 percent of the selling price.

(c) Determination of "selling price". In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the "selling price"; and for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§1.453-1 through 1.453-7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property. The term "payments" does not include amounts received by the vendor in the year of sale from the disposition to a third person of notes given by the vendee as part of the purchase price which are due and payable in subsequent years. Commissions and other selling expenses paid or incurred by the vendor shall not reduce the amount of the payments, the total contract price, or the selling price.

(26 C.F.R., Sec. 1.453-4.)

STATEMENT

The facts found by the District Court (R. 48-51) are not in dispute. The taxpayers, as sole proprietors, had been engaged in the business of selling agricultural seeds, fertilizers and supplies since 1920 in El Centro, California. They discussed with their accountants and attorneys the advisability of forming a corporation in order to bring a key employee and a third party into the organization. A corporation (Marshall Seed and Feed Company, a California corporation) was formed with an initial capital of $15,000 cash, of which $9,000 was contributed by the taxpayers, $3,000 by R. L. Wilson, and $3,000 by J. T. Tippett. (R. 49.)

The fixed assets of the taxpayers' business, including good will, were valued at $37,962.67. The taxpayers agreed to sell and transfer the current assets, fixed assets and good will of the business, of a total agreed value of $110,513.22, to the corporation in exchange for the corporation's assuming the current liabilities in the amount of $25,568.86, an account payable from the corporation to the taxpayers of $9,944.36, [1] and a promissory note from the

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1/ The statement in the pre-trial stipulation (R. 11) and in the District Court's findings (R. 49) referring to the $9,944.36 item as an account payable "from the corporation" to the taxpayers could be confusing because if it represented an obligation of the corporation, other than one assumed as a part of the purchase price of the business, it would not constitute a part of the payment received on the sale of the business. However, the statement of assets and liabilities referred to in the pre-trial stipulation (R. 12) as the document to be offered at the trial as Exhibit C (but not included in the reproduced record) lists this item, designated as "Accounts Payable--James H. Marshall" as one of the liabilities of the business assumed by the corporation in addition to the $25,568.86 current liabilities also assumed.

corporation for the balance of the purchase price in the amount of $75,000, payable at the rate of $500 per month, plus interest at 6 1/2% per annum. The sale was consummated April 1, 1959. No attempt was made to comply with the provisions of the California Bulk Sales Law contained in Section 3440.1 of the California Civil Code. (R. 49.)

The sale price for all of the assets sold was $110,513.22; the adjusted basis of the assets sold was $90,225.82; and the long-term capital gain resulting from the sale was $20,287.39. (R. 49-50.)

In 1959 the taxpayers received cash from such sale in the sums of $9,944.36, representing payment of the account payable to the taxpayers, and $4,000 as payment on the $75,000 promissory note, or a total of $13,944.36. In addition, the accounts payable of the business in the amount of $25,568.86 assumed by the corporation as a part of the purchase price were paid by the corporation to creditors during 1959 in the ordinary course of business. (R. 50.)

On April 15, 1960, the taxpayers filed a joint federal income tax return for the calendar year 1959 reporting an income tax liability of $5,725.05, all of which was duly paid. (R. 50.) Also, on their 1959 return [2/] the taxpayers elected to report the gain from the sale of their business on the installment basis in accordance with Section 453 of the Internal Revenue Code of 1954,

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2/ Referred to as Exhibit A in the pre-trial stipulation (R. 12), but not included in the reproduced record.

and reported long-term capital gain in the sum of $1,157.56 (only 50% of which was taxable) attributable to the $13,944.36 actually received in 1959.

In auditing the taxpayers' return for 1959, the Commissioner of Internal Revenue determined that the sale of the taxpayers' business did not constitute a sale the gain from which could be reported on the installment method permitted by Section 453 of the 1954 Code. Accordingly, he determined that the sale resulted in long-term capital gain for the year 1959 in the amount of $20,287.39, of which 50% was includible in taxable income, and, with other adjustments not in issue, assessed an additional tax for the year 1959 in the sum of $4,915.45, which the taxpayers paid on or about December 27, 1962, with assessed interest in the amount of $768.52. (R. 50-51.)

The Commissioner's determination that gain on the sale of the taxpayers' business was not taxable on the installment basis was based on the ground that payments received by the taxpayers in the year of sale included the $25,568.86 in current liabilities of the business assumed by the purchaser as a part of the selling price and actually paid in 1959, and that with this inclusion the payments received by the taxpayers in the year of sale exceeded 30% of the selling price within the meaning of Section 453(b) of the 1954 Code. (R. 51.)

The taxpayers duly filed a claim for refund of $3,936.23 of the additional taxes paid for 1959 on the ground that they were entitled to report the gain from the sale of their business on the

installment basis. (R. 51.) 3/ Upon failure of the Commissioner to allow the claim for refund, the taxpayers brought this action.

SPECIFICATION OF ERRORS RELIED UPON

The District Court erred in holding that, for the purpose of determining whether gain realized by the taxpayers upon the sale of their sole proprietorship business to a corporation in 1959 may be reported on the installment basis, the payments received by them on the purchase price in the year of sale did not, for purposes of Section 453(b) of the Internal Revenue Code of 1954, include the personal obligations of the taxpayers assumed and actually paid during the year of sale by the purchasing corporation as a part of the consideration for the sale.

SUMMARY OF ARGUMENT

In general, gain realized on a taxable sale or other disposition of property is taxable in the year of sale for federal income tax purposes. In the case of certain deferred payment sales of property, however, gain may be reported on the so-called installment basis as payments are received. In this case the

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3/ The alleged overpayment, as computed in a statement attached to the refund claim (R. between pp. 5 and 6) was computed by deducting from the selling price of $110,513.22 the current liabilities assumed by the purchaser ($25,568.86) and computing the profit ratio on the basis of a gain of $20,287.39 and a selling price of $84,944.36 (23.883%), instead of computing the profit percentage on the basis of the selling price of $110,513.22 as on their return. This resulted in a computed gain of $3,330.33 (50% taxable) attributable to the payments of $13,944.36, rather than a gain of $1,157.56 (50% taxable) reported on the 1959 return, and the gain of $20,287.39 (50% taxable) computed by the Commissioner. The complaint alleged overpayment of tax in the amount of $3,936.23 and overpayment of interest in the amount of $639.64. (R. 5.)

taxpayers sold their sole proprietorship business to a newly formed corporation in which they retained a controlling interest, the selling price to be paid by the assumption of certain liabilities, including the current accounts payable of the business, and the execution of a purchase money note payable in monthly installments over a period of years. The gain on the sale is taxable on the installment basis only if payments received in the year of sale did not exceed 30% of the selling price, and this in turn depends upon whether such payments include the current accounts payable of the business, which were actually paid by the purchaser in the year of sale.

Payment by a third party of an obligation of the taxpayer represents the constructive receipt of income, or, as in this case, the constructive receipt of payment of a part of the selling price of the business. The current accounts receivable were actually paid by the purchaser in the year of sale, and there is no authority for excluding the amount thus paid in determining whether payments received in the year of sale, for purposes of the installment provisions of the taxing statutes, did not exceed 30% of the selling price. The District Court erred in holding otherwise.

ARGUMENT

IN DETERMINING WHETHER GAIN FROM THE SALE BY THE TAXPAYERS OF THEIR SOLE PROPRIETORSHIP BUSINESS MAY BE REPORTED ON THE INSTALLMENT BASIS, THE PAYMENTS RECEIVED BY THEM IN THE YEAR OF SALE, WITHIN THE MEANING OF SECTION 453(b) OF THE INTERNAL REVENUE CODE OF 1954, INCLUDED THE PERSONAL OBLIGATIONS OF THE TAXPAYERS ASSUMED BY THE PURCHASER AS A PART OF THE SELLING PRICE TO THE EXTENT SUCH OBLIGATIONS WERE ACTUALLY PAID BY THE PURCHASER IN THE TAXABLE YEAR

That the taxpayers realized a taxable long-term capital gain in the amount of $20,287.39 upon the sale of their sole proprietorship business in 1959 is not questioned. The only issue for determination on this appeal is whether the realized gain is taxable in full in the year of the sale, as determined by the Commissioner of Internal Revenue, or whether, as claimed by the taxpayers and held by the District Court, such gain may be reported on the installment basis in the years in which payments on the sale price are received.

We respectfully submit the Commissioner properly taxed the gain in the year of sale.

One of the most basic principles of the federal income tax system is that taxable income shall be accounted for on an annual basis, and in accordance with the method of accounting regularly employed by the taxpayer in keeping its books and records. [4/] Thus,

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4/ See Sections 441 and 446 of the Internal Revenue Code of 1954, Section 41 of the Internal Revenue Code of 1939, and corresponding sections of prior Revenue Acts.

all income is required to be reported in gross income of the year in which it is received, unless under the method of accounting employed by the taxpayer it is to be accounted for as of a different period, 5/ and all deductions are to be taken in the year in which paid or accrued, according to the method of accounting used in computing taxable income. 6/

One of the major exceptions to this general requirement, commonly known as the installment method of reporting gains and profits, is contained in Section 453 of the Internal Revenue Code of 1954, supra, and the corresponding provisions of prior income tax laws. 7/ Subsection (a) of the latter section provides that under rules prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan "may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when

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5/ See Section 451 of the 1954 Code, Section 42 of the 1939 Code, and corresponding sections of prior Revenue Acts.

6/ See Section 461 of the 1954 Code, Section 43 of the 1939 Code, and corresponding sections of prior Revenue Acts.

7/ The installment method of reporting gains and profits is a variation on the cash method, and may be used in reporting gains and profits on sales which come within the statute regardless of whether the taxpayer regularly employs the cash or an accrual method of reporting income. Lucas v. North Texas Co., 281 U.S. 11; Burnet v. Logan, 283 U.S. 404.

payment is completed, bears to the total contract price." 8/ Subsection (b) of Section 453 upon which these taxpayers rely, further provides that income from a sale or other disposition of real property, or a casual sale or other disposition of personal property for a price exceeding $1,000, "may (under regulations prescribed by the Secretary or his delegate) be returned on the same basis and in the same manner prescribed in subsection (a)," but "only if in the taxable year of the sale or other disposition--(i) there are no payments, or (ii) the payments (exclusive of evidence of indebtedness of the purchaser) do not exceed 30 percent of the selling price."

In this case, the sale by the taxpayers of their sole proprietorship business to the new corporation in 1959 was a casual sale or other disposition of personal property within the meaning of this provision, and their gain is properly taxable on the installment basis only if the payments received in the year of sale, within the meaning of that subsection, did not exceed 30% of the selling price of $110,513.22.

The taxpayers contend that only the indebtedness of

8/ Paragraph (2) of subsection a provides that for the purposes of paragraph (1) that "the total contract price of all sales of personal property on the installment plan includes the amount of carrying charges or interest which is determined with respect to such sales and is added on the books of account of the seller to the established cash selling price of such property. This paragraph shall not apply * * * with respect to sales or other dispositions of property the income from which is, under subsection (b), returned on the basis and in the manner prescribed in paragraph (1). (Emphasis supplied.)

$9,944.36 owing to them, which was paid in the year of sale, and the monthly payments aggregating $4,000 received during 1959 on the purchase money note, which amount to less than 30% of the selling price, constitute payment received in the year of sale. On the other hand, the Government contends that the current liabilities of the taxpayers' business, which were assumed by the purchasing corporation as a part of the selling price and also paid during the taxable year, likewise constitute payment received in the year of sale within the meaning of the statute. It is not the contention of the Government that the mere assumption of the current liabilities of the business resulted in the receipt of payment by the purchasers, for the purposes of Section 453(b), because the assumption of such liabilities only represented one of the conditions of the sales agreement and their amount only represented a part of the consideration to be paid. Rather, it is the contention of the Government that <u>payment</u> of such assumed liabilities, for which the sellers remained primarily liable notwithstanding their assumption by the purchaser as a part of the selling price, represented payment by the purchaser of the selling price to that extent which was constructively received by the sellers in the year of payment--in this case, the year of sale.

The Government's position in this case is wholly consistent with applicable principles of income tax law. Gain from the sale or other disposition of property is determined independently of any statutory requirement for reporting such gain. Gain from the sale or other disposition of property (whether or not it is to be recognized

for income tax purposes and whether or not it is to be reported on the installment basis) is defined in the statute as the excess of the amount realized therefrom over the adjusted basis provided in the statute, and the loss sustained in any such transaction (whether or not deductible for income tax purposes) is the excess of the basis provided in the statute for computing loss over the amount realized. Section 1001(a) of the Internal Revenue Code of 1954. The "amount realized" for the purpose of determining gain or loss is "the sum of any money received plus the fair market value of the property (other than money) received." 9/ Section 1001(b) of the 1954 Code. The "amount realized" for property is not limited to the cash and fair market value of notes or other property actually received by the seller, but is generally the total consideration received, less

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9/ The "amount realized" for purposes of determining the amount of gain or loss on the sale or other disposition of property is not necessarily the same as the "total contract price" under Section 453(a) for determining "that proposition of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price" which is to be returned in income in the payment, or as the "selling price" on which the 30 percent limitation under Section 453(b) is to be computed. For instance, in the case of a deferred payment sale not on the installment method (where more than 30% of the selling price is received in the year of sale), evidence of indebtedness of the purchaser are treated as "property (other than money) received" within the meaning of Section 1001(b) and included at their fair market value in the "amount realized" for the purpose of computing gain or loss. On the other hand, if the sale qualifies as an installment sale taxable under Section 453, and the seller elects to report gain as payments are received, evidence of indebtedness of the purchaser are considered as potentially worth their face value in determining the "total contract price", a proportionate part of which is to be reported as payments are received. In the instant case the "total contract price" for purposes of computing the proportionate amount representing gain under Section 453(a), and the "selling price" for computing the 30 per cent limitation under Section 453(b), was $110,513.22.

expenses. The "amount realized", "selling price", or "total contract price", for the purpose of computing gain, so far as the present case is concerned, includes the liabilities of the seller assumed by the purchaser. Smith v. Commissioner, 324 F. 2d 725 (C. A. 9th), affirming decision of May 28, 1962 (P-H Memo T. C., par. 62,128).

In the cited case, the taxpayer sold his interest in a going business, the only consideration being the purchaser's assumption of current liabilities of the business greatly in excess of the taxpayer's adjusted basis of such assets. The taxpayer elected in his income tax return for the year of sale to report his gain on the so-called return of capital basis (Burnet v. Logan, 283 U.S. 404; Section 1.453-6, Treasury Regulations on Income Tax (1954 Code)), and attached a statement thereto listing assets in the amount $284,983.09, liabilities assumed in the amount of $603,687.96, and an excess of liabilities assumed over assets sold in the amount of $318,704.87, of which $142,493.39 was paid by the purchaser as of the end of the year of sale. In affirming the decision of the Tax Court holding the gain in that case taxable in the year of sale, this Court said (324 F. 2d, p. 726):

> The court properly held, as a matter of statutory construction, that the assumption of personal obligations of a taxpayer by a solvent third person may be treated as "money received" by the taxpayer, within the meaning of Section 1001(b) of the 1954 Code, to the amount of the obligations assumed. Cf. Crane v. Commissioner, 331 U.S. 1, 12-14, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947); Commissioner v. Fortee Properties, Inc., 211 F. 2d 915, 916 (2d Cir., 1954); Parker v. Delaney, 186 F. 2d 455, 458 (1st Cir., 1950); R. O'Dell & Sons Co. v. Commissioner, 169 F. 2d 247,

248 (3d Cir., 1948); Mendham Corporation v. Commissioner, 9 T. C. 320 (1947).

In Crane v. Commissioner, 331 U.S. 1, cited in the quotation above, real property acquired subject to mortgage later was sold subject to the same mortgage. The Supreme Court held that for the purpose of computing gain on the sale the mortgage balance was includible in the "selling price", although neither the seller nor the purchaser was personally liable on the mortgage. Parker v. Delaney, 186 F. 2d 455 (C. A. 1st), cited in the quotation above, is to the same effect. In Commissioner v. Fortee Properties, Inc., 211 F. 2d 915 (C. A. 2d), cited in the quotation above, reversing 19 T. C. 99, the court held that the amount of a condemnation award for the taxpayer's property which was paid directly to the mortgagee in discharge of a non-assumed mortgage on the taxpayer's property represented taxable gain to the taxpayer. In R. O'Dell & Sons Co. v. Commissioner, 169 F. 2d 247 (C. A. 3d), cited in the quotation above, the court affirmed the decision of the Tax Court, 8 T. C. 1165, holding that where the foreclosure of a mortgage and the sale of the mortgaged property have the effect under applicable state law of discharging the taxpayer's obligations in an amount greater than the adjusted basis of the property, the result is a taxable gain to the taxpayer in the year in which an action for a deficiency judgment becomes barred. Mendham Corp. v. Commissioner, 9 T. C. 320, cited in the quotation above, is to the same effect.

In the instant case, the terms of the sale included assumption

by the purchaser of current liabilities of the taxpayer's business in the amount of $25,568.86, which amount properly was included in the total contract price of $110,513.22 in computing the gain of $20,287.39. The current liabilities assumed by the purchaser were paid in full in 1959, the year of sale. (R. 49-50.) Payment of these current liabilities represented payment by the purchaser of the selling price to that extent. Payment of such liabilities, for which the sellers remained primarily liable notwithstanding their assumption by the purchaser, also represented constructive receipt by the sellers (taxpayers) of payments on the selling price to that extent. Smith v. Commissioner, supra; Commissioner v. Fortee Properties, Inc., supra; R. O'Dell & Sons Co. v. Commissioner, supra. Compare Old Colony Tr. Co. v. Commissioner, 279 U.S. 716; United States v. Boston & M.R. Co., 279 U.S. 732; United States v. Joliet & Chicago R. Co., 315 U.S. 44; Garrison Bros. State Bank v. Commissioner, 67 F.2d 486 (C.A. 9th); Reynolds v. McMurray, 60 F.2d 843 (C.A. 10th); T. K. Harris Co. v. Commissioner, 112 F.2d 76 (C.A. 6th); Tressler v. Commissioner, 228 F.2d 356 (C.A. 9th); Sowell v. Commissioner, 302 F.2d 177 (C.A. 5th); Diescher v. Commissioner, 36 B.T.A. 732, affirmed on another issue, 110 F.2d 90 (C.A. 3d), certiorari denied, 310 U.S. 650.

The taxpayers, in law and in fact, received constructive payment of the purchase price of their business in the amount of $25,568.86 in 1959 as a result of the payment of assumed current business liabilities in that amount by the purchaser in the year of

sale. It would have been no different from a tax standpoint if the purchaser had paid the $25,568.86 directly to the taxpayers and they had used the proceeds to pay the accounts payable. Compare Sterling v. Ham, 3 F. Supp. 386 (Me.). These payments, together with the payments admitted by the taxpayers, the payments received in the taxable year of sale exceeded 30% of the selling price, and the gain was properly taxed by the Commissioner as gain from a deferred payment sale not on the installment basis. Cf. Tombari v. Commissioner, 299 F. 2d 889 (C. A. 9th). See Treasury Regulations on Income Tax (1954 Code), Section 1.453-6.

Payment of the accounts payable by the purchaser constituted constructive payment of a part of the selling price to the taxpayers, under the facts of this case, for income tax purposes, and the term "payment" as used in Section 453(b) does not have a different connotation. There is no authority, statutory, decisional, or administrative interpretation, other than the District Court's decision in this case, for excluding the $25,568.86 thus paid by the purchaser in the year of sale from "payments" for the purpose of Section 453(b).

The District Court based its ruling herein on an assumed analogy between the unsecured current liabilities of the sellers assumed by the purchaser in this case and a mortgage indebtedness on the property transferred, which is accorded special treatment under Section 1.453-4(c), Treasury Regulations on Income Tax (1954 Code), supra for purposes of the installment sales provisions of the statute. The latter section provides, so far as material here,

that in the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, "shall, for the purpose of determining whether a sale is on the installment plan, be included as a part of the 'selling price,' " and that "for the purpose of determining the payments and the total contract price as those terms are used in section 453, and §§ 1.453.-1 through 1.453-7, the amount of such mortgage shall be included only to the extent that it exceeds the basis of the property." Thus, the amount of the mortgage, whether or not assumed by the purchaser, is included as part of the selling price upon which the 30% is computed but is not included in the "total contract price" for the purpose of determining the percentage of the payments to be recovered by the seller which is to be returned (either in the year of sale or over the contract period), as income when received, except to the extent that the mortgage exceeds the basis of the property.

There is no statutory authority for this so-called mortgage rule. However, it has appeared in Treasury Regulations since Treasury Regulations 69, Article 44, issued under the Revenue Act of 1926, and has been upheld as reasonable by the Supreme Court. Burnet v. S. & L. Bldg. Corp., 288 U.S. 406. See, also, Commissioner v. South Texas Co., 333 U.S. 496, 502-503. The rule, where appropriate, is applicable to sales or other dispositions of personal property as well as to sales or other dispositions of real property. I.T. 2468, VIII-1 Cum. Bull. 159 (1929); Cisler v. Commissioner, 39 T.C. 458, 465-466. Compare McWilliams v.

Commissioner, 15 B. T. A. 329, 342-343. However, the rule which excludes mortgages, whether or not assumed by the purchaser, for the purpose of determining the amount of "payments" and also for the purpose of determining the proportionate amount of "payments" to be reported as gain under the installment sales provisions of the statute has not been extended to unsecured obligations of the seller assumed and paid by the purchaser as part of the selling price. 10/ On the contrary, such unsecured obligations are included in determining the amount of payments received or to be received (and a corresponding portion of the taxable gain is attributed to them), as well as in determining the "selling price" and the "total contract price."

This method of computing the "selling price" and the "total contract price" applies in cases where the transferred property is subject to a mortgage as well as in cases where no mortgage is involved. In Watson v. Commissioner, 20 B. T. A. 270, a mortgage case, the Board of Tax Appeals failed to include unsecured liabilities of the seller assumed by the purchaser in "payments" received in the year of sale on the sole ground that the evidence

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10/ The District Court's reference in its opinion (R. 45-46) to 2 Mertens, Law of Federal Income Taxation (Rev. Ed.), Section 15.16 is with respect to debts of a vendor assumed by the purchaser as being treated in the same way as mortgages. However, the facts here show payment in the year of purchase and with respect to such a situation the same text writer states, 2 Mertens, supra, Section 15.18:

> A payment by the purchaser to a third party of an obligation of the vendor in the taxable period is included in the payments * * * .

in the year of sale determining if the payments in the year of sale exceed 30% of the selling price.

failed to show payment. Corona Flushing Co. v. Commissioner, 22 B. T. A. 1344, another mortgage case, such assumed liabilities were paid in the taxable year and were included in "payments" received in the year of sale, with the result that the installment method of reporting gain was inapplicable. In Wagegro Corp. v. Commissioner, 38 B. T. A. 1225, 1228-1229, a non-mortgage case, it was held that a payment by the purchaser of an attorney's fee of $750 incurred by the seller constituted a part of the selling price of the property. That payment, constructively received by the purchaser in the year of sale, was held to be an "initial" payment under Section 44 of the Revenue Act of 1932, c. 209, 47 Stat. 169, to permit use of the installment method, notwithstanding the fact that no payment on the agreed selling price was received.

McWilliams v. Commissioner, 15 B. T. A. 329, cited by the District Court (R. 45), is not authority for its decision here. The facts of that case, so far as pertinent here, are that a partnership, to whose interest the taxpayer had succeeded, had purchased property for a price of $440,000, of which $130,000 remained unpaid at the time of resale by the taxpayer. The latter unpaid balance was assumed by the taxpayer's purchaser. With respect to this assumed liability, the Board of Tax Appeals said in part (pp. 342-343):

> In the case before us the unpaid indebtedness of the seller in respect of the property, payment of which was specifically assumed by the purchaser, was not secured by mortgage but in all other respects was similar to a purchase money debt so secured. The seller in the transaction before us had acquired this property under a contract of purchase which obligated him to pay a stated

amount and the party from whom it was acquired retained title under that contract until the payments called for should be all made as provided instead of conveying title and then receiving back the legal title under a mortgage executed to secure the indebtedness. * * * The partnership of McWilliams & Pearson, the purchaser under this contract, and the petitioner, who had succeeded to its interest, had paid all of the purchase price of $440,000, with the exception of $130,000 at the time of the resale in 1921 under which the purchaser from this petitioner specifically assumed the payment of this unpaid balance.

In determining whether or not his last sale was one on the installment basis we see no difference between the assumption by the purchaser of the contract obligation of the seller to pay a former owner the balance of $130,000 due upon the property, and his assumption of a mortgage due that party and representing that item * * * . (Emphasis supplied.)

Moreover, it does not appear in the McWilliams case, as it does in the present case, that any payment was made on the assumed purchase price liability during the year of sale.

Denco Lumber Co. v. Commissioner, 39 T.C. 8, relied upon by the District Court (R. 45), is material here, but not as authority for its decision. Rather, to the extent it can be considered applicable, it is in accord with the Government's position in this case. In that case the taxpayers were engaged in the business of subdividing land into house building sites, constructing low-priced houses on those lots, and selling those houses and lots to individual home buyers. With the exception of a few homes, the taxpayers obtained first mortgage loans on the individual properties prior to their sale. When sold, there was no down payment, the purchaser merely assuming the first mortgage and giving the taxpayers a second mortgage for the difference between the first mortgage and the selling price. The Commissioner

determined that under the peculiar circumstances of that case the amount received by the taxpayers upon negotiation of the first mortgage on the property represented payment received on the sale. The Tax Court held (pp. 14-15), however, that the first mortgage loans were bona fide, not a mere device to bring the sales within the provisions of Section 453, and that gain was taxable on the installment basis in accordance with the principles discussed above.

Cisler v. Commissioner, 39 T. C. 458, also relied upon by the District Court (R. 46), likewise does not support its reasoning. In that case the taxpayer in September, 1952, sold 314 shares of preferred stock and 917 shares of common stock in Radio Kentucky, Inc., which he had acquired prior to January 1, 1952. The preferred stock had an adjusted cost basis on the date of sale of $15,700, and the common stock had a basis of zero. The stock was sold to Radio Kentucky, Inc., in a single transaction, the selling price of the preferred stock being $15,700, with no gain realized, and the common stock being sold for $44,300, all of which represented taxable gain. With the consummation of the sales agreement, Radio Kentucky, Inc., cancelled an indebtedness of the taxpayer to it in the amount of $13,663.53, and paid him cash in the amount of $2,036.47, a total of $15,700. Radio Kentucky, Inc., also assumed, as a part of the selling price, an outstanding indebtedness of the taxpayer to a third party in the amount of $20,000 for the payment of which the taxpayer had pledged his 917 shares of common stock as security. Furthermore, Radio Kentucky,

Inc. gave the taxpayer four promissory notes, the first three for $4,000 each and the fourth for $4,300, payable with 5% interest on May 15, 1953, August 15, 1953, January 15, 1954, and March 15, 1954, respectively. During the remainder of the taxpayer's taxable year Radio Kentucky, Inc., paid $3,000 on the assumed indebtedness and paid $8,000 on its notes to the taxpayer.

In that case the taxpayer contended that the sale of his stock consisted of two transactions, the sale of his preferred stock, which was paid in full with no resulting profit, and the sale of his common stock for $44,300 on which he received a payment of $11,000, of which $8,000 was paid to him and $3,000 was paid on his personal liability assumed by the purchaser. (Id., pp. 463-464.) On the other hand, the Commissioner contended that the sale constituted a single transaction with payments on the selling price of $60,000 amounting to $43,700 in the year of sale, 11/ and, alternatively, if treated separately, the taxpayer received $28,000 on the common stock ($20,000 assumption of indebtedness and $8,000 in notes) in the year of sale. The Tax Court rejected the contention of the taxpayer, holding, among other things, that the assumption of indebtedness of the seller constituted (p. 465) "Other 'property' " includible in "payments" as that term is used in Section 453(b). The Tax Court further pointed out that the so-called mortgage rule admittedly otherwise applicable under I. T.

11/ Consisting of canceled indebtedness of $13,663.53; cash on consummation, $2,036.47; assumption of personal indebtedness of $20,000; payment on notes, $8,000.

2468, <u>supra</u>, was inapplicable there because the taxpayer's cost basis in the common stock was zero, and under that rule mortgages are excludable from payments only to the extent the mortgage does not exceed the seller's basis of the property.

Moreover, many of the decisions cited above make it clear that an assumption by the purchaser of an indebtedness of the taxpayer to third parties is not to be treated differently, for the purpose of determining "payments" under the statute, from other forms of payment in "Other 'property'." Compare <u>Caldwell</u> v. <u>United States</u>, 114 F. 2d 995 (C. A. 3d); <u>Freeman</u> v. <u>Commissioner</u>, 303 F. 2d 580 (C. A. 8th). Numerous cases to the same effect could be cited.

Finally, the District Court's conclusion that because under the Regulations mortgages are excluded to the extent they do not exceed the taxpayer's basis in determining "payments" actually received in the year of sale, "by analogy, therefore, it should logically follow that the assumption of plaintiffs' accounts payable should in no way be considered as 'payments actually received in that year' of sale anymore [<u>sic</u>] than the assumption of a mortgage in a real estate transaction is" (R. 45), lacks merit. Mortgage payments frequently extend beyond the period when the seller has received the full amount to be paid him under the sales agreement, and to include subsequent mortgage payments, or even interim mortgage payments, in his income would present many practical difficulties. <u>Burnet</u> v. <u>S. & L. Bldg. Corp.</u>, <u>supra</u>, shows that the longstanding regulation with respect to determination of "selling

price" in the sale of mortgaged property is predicated upon the administrative inconvenience which would be incurred if the mortgage were not excluded from the contract price. In S. & L. Bldg. Corp., supra, the taxpayer argued that assumed mortgages should be regarded as part of the contract price and that payments upon them by the purchaser should be treated as money received by the vendor. The taxpayer asserted that this would result in spreading the tax over the entire life of the assumed mortgage. The Court, in rejecting this contention, stated (pp. 414-415):

> The amounts which respondent realized as profits are not in question. These were subject to taxation either upon the accrual basis or, at the taxpayer's option, on the installment basis. Generally, the Commissioner's regulations permitted the tax payments to be spread over the period during which the taxpayer would receive funds, and divided these partly into return of capital and partly into profits actually collected. The method suggested by the respondent would inevitably lead to many practical difficulties; might postpone collection far beyond the time when the vendor would receive any direct payments; and probably would render impossible determination from the taxpayer's books of what he should account for. (Emphasis supplied.)

The Secretary of the Treasury, in promulgating his regulations, could have treated other charges against the property, such as mechanic's liens, in the same manner as mortgages. However, he chose not to do so. There is justification for the difference. If a payment on a mortgage were considered as a payment of an installment, the treatment of an installment would be complicated by two sets of installment payments running over two different periods of time. Thus, if a purchaser assumes a mortgage with a ten-year payoff, but was to pay the seller over a

four-year period, numerous difficulties would be encountered. For example, if it were said that each individual payment on a mortgage were to inure to the vendor's benefit, how would the vendor be treated if the purchaser prepaid the balance due on said mortgage after two years instead of ten? How should a vendor be treated if the purchaser were to refinance and obtain a new mortgage for a twenty-year period? It is these problems which the Supreme Court undoubtedly foresaw in S. & L. Bldg. Corp., supra.

Assumption and payment of charges, such as mechanic's liens and/or current liabilities, do not give rise to the difficulties encountered in the mortgage situation. The very nature of these charges would generally result in a single payment by the purchaser or a few payments in a short period of time. The benefit derived by the vendor would be capable of immediate measurement, e.g., current liabilities paid by the purchaser relieve the vendor of a current obligation. The conjecture and administrative difficulties involved in the mortgage situation would not be present. Accordingly, the reason for the mortgage exclusion does not exist in a situation wherein the purchaser assumed and pays the current liabilities of the vendor. 12/

12/ In Rev. Rul. 60-52, 1960-1 Cum. Bull. 186, it is held that in connection with the sale of real property, liabilities of the seller such as liens, accrued interest, and taxes, which are assumed and paid by the purchaser of the property in the taxable year of sale, should be included by the seller as part of the payments received in the year of sale for the purpose of determining whether the transaction was an installment sale subject to the provisions of Section 453(b) of the Internal Revenue Code of 1954. It appears

(continued on following page)

CONCLUSION

The District Court's decision is contrary to the facts and the law. Its judgment should be vacated and the case remanded to that court with directions to dismiss the complaint. 13/

Respectfully submitted,

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SEPTEMBER, 1965.

12/ (continued from preceding page) that this ruling is a logical extension of the proposition that all assumed obligations which are paid in the year of sale should be treated as initial payments under Section 453 unless there are compelling administrative reasons not to so treat them.

13/ In the event that notwithstanding the contentions made by the Government in this brief, this Court should decide to affirm the decision of the District Court, it is suggested that the judgment (R. 53) which now reads that "plaintiffs * * * recover from, defendant UNITED STATES OF AMERICA the sum of $5,121.30 together with interest from January 4, 1965, at the rate of seventy-five cents (75¢) per day to with $15.75 making a total payment of $5137.05" should be rephrased so as to read "IT IS ORDERED, ADJUDGED AND DECREED that plaintiffs JAMES H. MARSHALL and THELMA MARSHALL have judgment against, and recover from, defendant UNITED STATES OF AMERICA as an overpayment
(continued on following page)

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 28th day of September, 1965.

/s/ James S. Bay

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13/ (continued from preceding page) the sum of $4,575.87 with interest thereon as provided by law." The "law" is 28 U.S.C., Section 2411(a), which provides that interest shall be allowed at the rate of six percent per annum upon the amount of the overpayment, from the date of payment or collection to a date preceding the date of the refund check by not more than thirty days. The figure $4,575.87 is made up of the deficiency ($3,936.23) plus assessed interest ($639.64), which was paid at some date in December, 1962. The sum of $5,121.30 presently stated in the judgment apparently represents $4,575.87 plus $545.43 interest from December 31, 1962 to January 4, 1965. The District Court apparently added $15.75 interest from January 4, 1965 to date of entry (January 25, 1965). It seems desirable from an administrative viewpoint for purposes of interest calculation that judgments for tax overpayments follow a uniform pattern, such as that suggested above.